2.11 AUDITING

The origin of auditing can be traced to Italy. Around the year 1494, Luca Paciolo introduced the double entry system of bookkeeping and described the duties and responsibilities of an Auditor.

Auditing

Auditing in India has been described in different ways ?

"Auditing is a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing situation, the Auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis, formulates his judgment which is communicated through his audit report."

-The Institute of Chartered Accountant of India

Another definition goes as such ?

"Auditing is an intelligent and critical scrutiny of books of accounts of a business with the documents and vouchers from which they have been written up, for the purpose of ascertaining whether the working results of a particular period as shown by Profit and Loss Account and also the financial position as reflected in the Balance-sheet are truly and fairly determined and presented by those responsible for their compilation."

- J. R. Batliboi

Auditing in India

Let us now understand the growth of auditing in India. The Indian Companies Act, 1913, prescribed for the first time the qualifications of an Auditor. The Government of Bombay was the first to conduct related courses of study such as the Government Diploma in Accountancy (GDA).

The Auditor's Certificate Rule was passed in 1932 to maintain uniform standard in Accountancy and Auditing. The Chartered Accountant Act was enacted by the Parliament of India in 1939. The Act regulates that a person can be authorized to audit only when he qualifies in the examinations conducted by The Institute of Chartered Accountants of India.

Following are a few other points related to Auditing in India ?

- Members of Institute of Cost and Works Accountant of India are authorized to conduct cost audit according to Section 233-B of the Companies Act, 1956.
- Companies Act 1931 was replaced by Companies Act 1956.
- An Auditor can be appointed only by a special resolution as per section 224 The Companies (amendment) Act, 1974.

Bookkeeping

A Bookkeeper records day-to-day transaction in the books of accounts in a systematic manner. Bookkeeping includes ?

- Journalizing
- Posting to ledger
- Totaling and balancing of ledger accounts

Accountancy

The job of Accountancy begins where bookkeeping ends and includes the following ?

- Rectification of errors
- Preparation of Trial Balance
- Preparation of financial statements (Trading and Profit & Loss account and BalanceSheet, etc.)

Auditing

Preparation of accounts is not the duty of an Auditor. "Auditing begins, where accountancy ends". Auditor is only concerned for checking and verification of records. Auditor is a qualified person appointed for the purpose of certification of work done by others.

Investigation

An investigation may be done with a specific purpose. It is usually conducted to know the financial position of a business, extent of fraud and misappropriation and the earning capacity of any business unit, etc. The time duration for investigation may also extend beyond one year. Investigation may not be necessarily done by a qualified Chartered Accountant.

Qualities of an Auditor

An Auditor must have the following qualifications and qualities ?

- He should be a qualified Chartered Accountant or he should be a qualified member of The Institute of Cost & Works Accountants of India to do cost audit.
- He must have adequate skills and qualities to conduct his work efficiently.
- An Auditor must be honest, impartial and unbiased. He should also be hard-working, have adequate common sense, capacity to hear arguments of others, systematic and methodical.
- An Auditor should ask for clarification on matter on which he is unable to understand the information provided to him.
- His audit report should be correct and clear.
- In case where any suspicious situation arises, he should assume that he is dealing with dishonest and fraudulent peoples.
- He must have thorough knowledge of accounting principles and practices.
- He must have the know how of all the domestic and international court case decisions.
- He must have thorough knowledge of financial management, industrial management and business organizations.
- He must have up-to-date knowledge of the Mercantile law and the Companies Act.

Scope of Auditing

In comparison with earlier days, where the main objective of auditing was to detect fraud, we now have enhanced ways to determine a true and fair view of financial statements. In recent times, almost every country of the world has introduced various legislations and framed rules and regulation of auditing. In India also legislations related to Tax Audit, Cost Audit, Management Audit and operation Audit, etc. are coming up.

The main purpose of auditing is to certify the correctness of financial statements and to detect errors and frauds.

Techniques of Auditing

Following are the common techniques of auditing ?

- Checking of posting and casting.
- Physical verification of assets.
- Verification and examination of transactions with available evidences.
- Scrutiny of the books of accounts,
- Checking of various calculations.
- Checking of carried forward balances in next year.
- Checking of Bank reconciliation statements.
- Auditor can get information from inside and outside sources of organization.

Detection and prevention of fraud

The main objective of auditing is to ensure the financial reliability of any organization; detection of fraud is just an incidental object.

Independent opinion and judgement form the objectives of auditing. The job of an Auditor is to ensure that the books of accounts are kept according to the rules stipulated in the Companies Act; an Auditor also needs to ensure whether the books of accounts show a true and fair view of the state of affairs of the company or not.

The following are the three distinct types of fraud ?

- Misappropriation of Cash
- Misappropriation of Goods
- Manipulation of Accounts

Misappropriation of Cash

Misappropriation of cash is the easiest way of fraud especially in large business houses where there is limited or no communication between the owner of an organization and the cashier. Following are some of the ways through which embezzlement or misappropriation can be done ?

- Theft of cash receipts and petty cash and showing fictitious payment to workers, creditors, purchases, etc.
- Showing false payments or excess payments in cash book.
- By using the **Teeming** and **Lading** method, the money received from any customer can be pocketed and the money received from another customer can be shown as money received from the former.
- Cash sale can be shown as credit sale.

Strict internal control system should be followed in receipts and payments of cash so that the work done by one person should be automatically checked by another person.

Misappropriation of Goods

Misappropriation of goods can be done in the following ways ?

- Goods may be stolen by employees or with the help of employees.
- By issuing false credit notes to customer on account of goods return.

Detection of misappropriation of goods is more difficult rather than detecting misappropriation of money, especially where management is not much vigilant and sound system of book-keeping, internal control and adequate system of securities are not available. To keep control on the physical verification of goods, reconciliation of physical stock with books and careful checking of sale and purchase is must.

Manipulation of Accounts

Two types of manipulation of accounts are mainly done by top management to mislead some parties for some specific purpose.

Showing higher profits – Following are the reasons behind showing higher profit than actual–

- To obtain credit or to enhance existing credit from financial institutions and also to show credit worthies to suppliers of the company.
- To maintain confidence of shareholders.
- To hike the market price of shares of the company and enable the sale of those at higher price, it may be done by declaring higher dividends on shares.
- To get more commission where commission is calculated on the basis of profit earned.
- To declare dividend at higher rate.

Showing low profits – Following are the reasons behind showing lower profit than actual –

- To avoid or to reduce Direct Taxes of the company (Income Tax, Wealth Tax).

- To purchase shares at lower price.
- To give wrong impression to the other competitors of the business.

Manner of Manipulation of Accounts

Manipulation of accounts may be done in the following ways –

* **Window dressing** is a manipulation or miss-representation of financial data in such a way that it seems better than what it actually is. Some of the method of window dressing is given as hereunder.
  - Over valuation of closing stock
  - Under valuation of Liabilities or Over-valuation of assets
  - Purchases and expenses of current year may be deferred to next financial year
  - Charging revenue expenses as capital expenditure
  - Sale and other incomes of preceding year may be shown as income or sale of the current year.
* Secret reserves of previous years may be used in the current financial year to inflate the profit or secret reserves may be created to suppress the profit of the current financial year.
* Stock may be under or overvalued. Income and sales may be suppressed or inflated. Expenses and purchases may be suppressed or inflated.

Detection and prevention of error

Auditors should be very careful about the detection of errors because manipulation in accounting may also appear as error or it may be a result of carelessness on part of a bookkeeper.

Errors may be broadly classified as follows —

- Error of Principle
- Errors of Omission
- Errors of Duplication
- Errors of Commission
- Compensating Errors

Error of Principle

Where the recording of the items of transactions are not done according to the Principle of Accounting, it is known to be an error of principle. These errors are not traceable from trail balance; these errors may be committed unintentionally or for the purpose of manipulation of accounts to inflate or deflate profit.

Following are the examples of such type of errors —

- Providing excessive or inadequate depreciation
- Where the provision for outstanding expenses or prepaid expenses is wrong
- Where revenue expenses may be treated as capital expenditure or vice versa
- Where valuation of Plant & Machinery, Stock, investment and other assets are not done according to the Principle of Accounting.
- Where income received is credited to personal account of the person who is making the payment; for example, commission received from Mr. A credited to Mr. A's account instead of the commission account, it will increase creditors in the Balance Sheet and reduce profit in the Profit & Loss account.
- Where the payment of expenses is posted to the personal account of a person who receives payment; for example, the rent paid to Mr. A wrongly debited to Mr. A's account, it will increase profit and also increase debtors in the Balance-sheet.

Errors of Omission

There may be two types of omission of entry while recording the transactions in the books of accounts;

- Where transaction is totally omitted from the books of accounts, it will not affect the trial balance and the detection of such error is difficult. Following are the examples of such errors;
  - Omission of purchase or sale from the purchase day book or the sale day book respectively.
  - Omission of outstanding or unpaid expenses.
- Examples of the transactions which are partially omitted from the books of accounts are—
  - Where total of purchase day book or sale day book omitted to be posted in purchase or sale account respectively.
  - Where payment or receipt transaction omitted to be recorded in ledger account from cash book.

Errors of Duplication

The detection of error of duplication is very difficult. It might be detected with proper and minute observation of accounts; for example, purchase may be recorded twice with original and duplicate copy of purchase invoice, etc. It is also possible to post the total of any ledger account twice in the trial balance.

Errors of Commission

Error of commission occurs the entry made in the books of the original entry or the ledger account is wrong. Let us see the following examples —

- Purchase of goods for Rs. 25,000 wrongly entered as Rs. 2,500 in purchase book.
- Credit purchase from AB Company wrongly credited to BA Company's account.
- Wrong totaling – total of purchase day book is totaled as Rs. 1,12,500 instead of 1,21,500.
- Purchase from AB Company wrongly debited to AB company account instead of crediting AB company account and debiting purchase account.

Compensating Errors

When the effect of an error compensates with another error; it is known to be a compensating error. Such errors do not affect the trial balance; for example, total of a debit account as well as credit account totaled short by Rs. 7,500. This type of error will compensate both.

Prevention of Errors and Fraud

After the completion of audit, the Auditor can suggest his client to make changes in the accounting systems and also to improve his internal control system as an Auditor cannot do anything directly to prevent errors and frauds.

Auditors are expected to conduct audit as per professional standards expected from him. He cannot guarantee that no fraud exists. An Auditor should ensure and follow these standards ?

- Internal control system
- While recording the business transaction whether accounting principle are being followed or not
- Policies of management are being followed or not
- Whether provisions laid in the Companies Act are being followed while preparing books of accounts
- Whether Balance-sheet and Profit & Loss account show true and fair view of state of affairs of concern

Following factors decide whether an Auditor is responsible for non-detection of errors and frauds —

- An Auditor should audit as per the principles laid out for auditing.
- He should fulfil his duty as per the prevailing standards of his profession.
- Error should be rectified during his audit and fraud is to be reflected in his audit report.
- Even a simple hint that reflects that there is something wrong should not be overlooked.
- He should believe on substantial accuracy in statement of accounts.

Auditing - basic principal

Planning

An Auditor should plan his work to complete his work efficiently and well within time. To plan work accordingly, an Auditor handles the following ?

- Accounting system and policies.
- Internal control system of organization.
- Determination of audit procedures and coordinating audit work.

Honesty

An Auditor must have impartial attitude and should be free from any interest. He should be honest and sincere to his work and he should do his work without any bias and prejudice.

Secrecy

An Auditor should keep confidential all the information acquired by him during his audit. He should not share the information with anyone without the permission of the client and that too the information can be shared with the client's permission only when it is bound to be so.

Audit Evidence

An Auditor should adhere to substantive and compliance procedure for collecting audit evidences before conducting an audit. Through substantive procedures, an Auditor may collect evidences regarding accuracy, completeness and validity of data; and through compliance procedure, he may collect evidences regarding internal control system as used in the client's organization.

Internal Control System

It is the primary responsibility of a company to keep adequate internal control system in his organization. On the basis of such internal control system, an Auditor can determine the nature, timing and audit procedure to be applied to conduct his audit.

Skill and Competence

Audit should be done by trained, experienced and competent persons and audit staff should be updated with all the developments in accounting, auditing and legal rules and regulations as amended from time to time.

Work Done by Others

An Auditor is permitted to rely on work done by others but he should exercise due diligence when referring to it. He should mention the source of reference thereof in his report.

Working Papers

An Auditor should prepare and preserve all the necessary documents as obtained during his audit. These documents can be used by him as audit evidences.

Legal Framework

All business activities should be run adhering to the rules and regulations stipulated in the legal framework. This is to safeguard the interests and rights of the interested parties.

Audit Report

On the basis of the review and assessment of the audit evidences, Auditor should express his opinion regarding financial statements of an organization —

- Financial statements are prepared using acceptable accounting principles.
- Financial statements comply all relevant statutory requirements.
- All material matters are disclosed and proper presentation of financial statements are done subject to statutory requirements.

Auditing - Advantage

Following are the main advantages of auditing for different stakeholders —

For the Owner and Shareholders

- Sole proprietor of a business and partners of firm can rely and depend on audited financial statements.
- Auditing is helpful for valuation and business settlement at the time of admission of new partner, retirement or death of a partner. This avoids the risk of any dispute in a firm.
- Audited financial statement is the only way out for shareholders to judge the performance of the management of the company.

For the Management

- Auditing is helpful in detecting frauds and prevention of errors.
- It helps to keep the staff vigilant; as eventually the work done by them goes for an audit.
- Insurance claim can be easily estimated from audited accounts.
- Management can take advantage of expert advice of Auditor in financial matters.
- Comparison of financial statements of different years becomes easier.
- Assessment of Tax Liabilities is easy.

For the Government

Taxation authorities and all other Government authorities rely on audited financial statements; even the courts accept these as evidence when the situations call for.

For the Creditors

Creditors of an organization also rely on audited financial statements and accordingly grant credit limit to business entities.

For Others

- Audited accounts are easily accepted by insurance companies for settlement of claims.
- Audited financial statements are acceptable by bank and financial institutions and helpful in getting loans and credit facilities.

Auditing - limitations

Following are a few limitations of auditing —

- **Rely on Experts -** An Auditor has to rely on experts like engineers, valuers and lawyers for estimation and valuation of fixed assets and estimation of contingent liabilities.
- **Efficiency of Management -** An Auditor does not comment on the efficiency of management working in client organization; no comments on future performance of an organization can be made through audited financial statements.
- **Checking of All Transactions -** It is not possible for an Auditor to check all business transactions especially in big organizations where the number of transactions is very high. An Auditor has to rely on sampling and test checking.
- **Additional Financial burden -** An organization has to bear additional financial burden on account of any fees and other such expenses for conducting an audit.

- **Not Easy to Detect Some Frauds -** It is not easy for an Auditor to detect deeply laid frauds like forgery, misstatements and non-recording of transactions.

Vouching

Accounting entries made in the books must be supported by documentary evidence and inspection of that evidence is called vouching. The Auditor judges the authenticity, of the accounting entries using the technique of vouching. In case of unavailability of proper supporting documents, the Auditor may have all reasons to doubt about errors or fraud or manipulation.

Thus, auditing is incomplete without vouching.

In auditing process, based on evidence, there are two main functions

- collection of evidences - through observation, confirmation, inspection, inquiry.
- evaluation of evidences - with relevance, adequacy and validity.

Objective of Vouching

Following are the main objectives of vouching ?

- To check whether all the business transactions are properly recorded in the books of accounts or not.
- To see whether recorded transactions are duly supported by documentary evidence or not.
- To verify that all the documentary evidence is authenticated and related to business transactions only.
- To verify that transactions are free from errors or frauds.
- To verify whether voucher is processed through all the stages of Internal Check system properly.
- To verify and confirm that the entries are recorded according to the capital and the revenue nature or not.
- To check the accuracy of accounting transactions.

Importance of Vouching

Vouching forms the base for auditing and has an important part of Auditor's duty. In case of negligence in vouching, the Auditor will be held responsible; he cannot escape from his duty, if he has done vouching carelessly. Following points show the importance of vouching ?

- Vouching is equally important as passing of original entry in the books of accounts. If, original entry is wrong, it will affect every process of accounting entry and its impact will be till the end result. Similarly, vouching is base of all auditing process.
- Efficiency of vouching will decide the success of audit.
- Any errors and frauds are easily detectable if vouching is conducting in searching and intelligent manner.
- Intelligent and faithful vouching will establish reliability on financial statements, i.e., Profit and Loss account and Balance Sheet of any organization.
- If adequate internal control system exists, the Auditor may choose to do test checking instead of complete vouching.

Vouching and Routine Checking

Routine checking covers the checking of every carry forward, posting to ledger account and balancing of account. Vouching includes routine checking which is a mechanical checking, whereas vouching is made on the basis of documentary evidence.

A voucher may be a sales bill, purchase bill, payment receipt, pay-in slip, etc. All such types of documentary evidence are known as vouchers.

Types of Voucher

There are two types of vouchers —

- **Primary Voucher -** Original copy of written supporting document is called primary voucher. Like purchase Bill, cash memo, pay-in-slip, etc.
- **Collateral Voucher -** Copies of supporting documents which are not available in original are collateral voucher like duplicate or carbon copy of sale invoice.

Example of Vouchers

Transactions	Vouchers
Sales	Sales order, sales invoice, goods outward register, cash receipt, bank pay-in-slip, etc.
Purchase	Quotations, purchase orders, purchase bills, goods inward register, etc.
Cash Payments	Demand note, cash receipt, cash memo, etc.
Cash Received	Duplicate or carbon copy of cash receipt, contracts and correspondence with payee, etc.
Bank Payments	Cheques, counterfoils, bank statements, etc.
Payment received through Banking Channels	Bank deposit slip, bank statements, etc.

Important Points Regarding Vouching

Following points need to be considered regarding vouching —

- Accuracy of transactions.
- Authenticity of transactions.
- Proper classification of accounts.
- Voucher should be properly numbered serially and arrangement of vouchers accordingly.
- Every checked voucher should be tick marked with sign.
- Amount of receipt should be same in words and in figure.
- Period of payment should be there on receipt.
- Receipt should clearly mention "advance payment" if it is do.
- To check and investigate the books of accounts if they are in the name of Director, Manager, Partner or any other employee of the company.
- To verify that proper certification of voucher should be there by any responsible officer of the company.
- Investigation about missing vouchers in file if any.

- Every alteration in voucher must be authenticated by concerned officer.
- Vouching should be complete at once in one sitting for a particular period of time.
- All the expenses should be examined by the Auditor.
- Without existence of adequate internal control system in organisation, an Auditor should not opt for test checking.
- Checking the classification of account must be done.
- Cash purchase should not be recorded twice, once in cash purchase and second one in credit purchase.
- An Auditor should refer the resolution as passed at the meeting for certain transactions.
- An Auditor should verify that accounting entries are done on the basis of capital and revenue items.
- An Auditor should verify that every payment voucher of above Rs. 5,000/- should bear the revenue stamp.

Verification

Verification means the inspection of assets appearing in financial statements, whether the assets are according to legislation or not. Verification of assets and liabilities are done to confirm the following—

- Existence
- Ownership
- Proper valuation
- Possession
- Freedom from encumbrances
- Proper recording

Objectives of Verification

Following are the objectives of Verification —

- Confirmation about the existence of assets through physical verification.
- Legal and official documents relating to assets are checked to confirm the ownership of assets.
- It is confirmed that assets are free from any charge of lien.
- Proof regarding proper valuation of assets.
- To confirm that assets are properly accounted for in the books of accounts.

Vouching and Verification

Both are considered to be same thing but there are lots of difference between vouching and verification.

Vouching relates to confirmation of the correctness and authenticity of accounting entries as appeared in the books of accounts whereas verification confirms the existence, ownership and valuation of assets as appears in the balance sheet. The Auditor's duty is not only vouching the entries appearing in the books because vouching cannot prove the existence of the related asset or liabilities at the balance sheet date.

Verification of Liabilities

Following are the objectives of verification of liabilities —

- Creditors reflect a true position as to liabilities of the business.
- All liabilities are disclosed in the balance sheet whether recorded in the books or not.
- Value of liabilities is according to the generally accepted accounting principles.
- Liabilities are properly classified and disclosed in the balance sheet.

Confirmation and Verification

Let us now understand what confirmation and verification is.

Confirmation

Auditor requires confirmation from third party and management about any fact or figure. Few of the examples in which the Auditor requires confirmations are as follows —

- Confirmation from debtors about balances.
- Confirmation from creditors about balances.
- Confirmation from banks about bank balances, fixed deposits, interest accrued, overdraft or cash credit limit balance, etc.
- Confirmation from financial institutions about loan and interests.
- Confirmation from management about contingent liabilities, etc.

Verification

Verification means inspection of assets by the Auditor and it includes identification, weighing and counting of assets. Following items require physical verification ?

- Land and Building
- Plant and Machinery
- Stock-in-hand
- Stores and consumables
- Investments
- Securities
- Cash-in-hand
- Bills receivable

Thus, confirmation and verification are altogether different processes of audit and both are equally important too.

Valuation of Assets and Liabilities

Valuation means estimation of various assets and liabilities. It is the duty of Auditor to confirm that assets and liabilities are appearing in the balance sheet exhibiting their proper and correct value. In the absence of proper valuation of assets and liabilities, they will exhibit either overvalued or under-valued.

It is therefore required for an Auditor to exercise reasonable care and skill to analyze the basis of valuation from technical experts and satisfy himself that assets shown in Balance-sheet are properly valued accordance with the generally accepted conventions and accounting principles.

Components of Valuation

Methods of valuation of assets are as hereunder —

- **Cost Price -** This is the cost price paid at the time of acquisition of assets plus the freight charges, octroi charges, and commissioning and installation charges, etc. to bring that asset in usable condition.
- **Book Value -** This is the value as appearing in the books of accounts; the cost price less depreciation.
- **Realizable Value -** A Value which can be realized from the sale of assets.
- **Market Value -** A value which the asset can fetch at the time of sale.
- **Replacement Value -** A value on which an asset can be replaced.
- **Conventional Value -** It means the cost price less depreciation written off ignoring any kind of fluctuation in the price.
- **Scrap Value -** If the asset is not in working condition and sold as scrap, then the sale value of asset is scrap value.

Basis of Valuation

Auditor should ensure that the basis of valuation is correct and reliable. He should keep in mind the process of valuation which is as follows ?

- Original cost
- Expected working hours of the assets
- Wear and tear expenses
- Scrap value
- Chances of asset become obsolete

Fixed asset is valued at cost price less depreciation and current assets should be valued at cost or market price whichever is less.

Vouching, Verification and Valuation

In vouching, accounting entries are checked with the bona-fide vouchers.

- Verification proves the **existence, ownership** and title of assets.
- Valuation certifies the **correct value of asset**.
- Vouching is done after **original entr**y in the books of accounts.
- Verification and valuation are done at the **end of the financial year**.
- Vouching is done by **Senior Auditor** and **Audit Clerk.**
- Verification and valuation are done by the **Auditor** himself.
- Bonafide vouchers are sufficient **evidence** for vouching
- For Valuation Auditor has to depend upon **certification** from owner/partner/director.
- Verification is done by physical verification, title deeds and receipt of payment, etc.

Verification and Valuation of Copyright

We will now discuss the verification and valuation of Copyright —

Copyright

Copyright provides legal protection and legal rights to an author by which the publication of his work by another is prohibited. Copyright remains with the author for lifetime and even 50 years after his death.

Verification of Copyright

- The Auditor should examine the agreement between the author and the publisher.
- If there are numbers of copyright with the same publisher. Auditor should ask for the schedule of copyrights.

Valuation of Copyright

Copyrights lose their value over a passage of time; hence the value of copyright is not stable. In case where the sale of publication is very low or nil, value of copyright should be written off.

Value of copyright in the Balance-sheet will be shown as cost less the value written off.

Verification and Valuation of Fixed Assets

We will discuss the verification and the valuation of different fixed assets —

Verification of Freehold Land and Building

- Auditor should examine the title deed of the land and building.
- Land and building shown in the books should be according to the title deed.
- Profit or loss on sale of it should be duly adjusted in the account.
- Any addition to it should be carefully examined by the Auditor.

Verification of Mortgage Property

- The Auditor should confirm that there should be no second or third mortgage on it.
- The Auditor should obtain certificate from mortgagee that title deed is in his possession.
- The Auditor cannot be held responsible if there is any defect of title. The Auditor can only verify that title deed apparently in order and in the name of client.
- If Auditor feels necessary he can obtain certificate from legal advisor about the validity of title deed of the client.

Valuation of Building

- Building should always be valued at cost less depreciation.
- Although the market value of building may be much higher than the cost, still depreciation on building should be provided.
- Depreciation will be provided even if building is not in use.
- Market or releasable value should not be taken into account because both are fluctuating.

Verification of Freehold Land

- Freehold land is a non-depreciable asset, hence it will be shown at cost.
- Cost includes legal charges, registration fees, purchase price and broker commission, etc.
- Payment made to improvement trust or Municipal Corporation for water, sewerage, road, development charges, etc. it will also be included in the cost of the freehold land.
- If the basis of valuation of it is market value or realizable value, it should be clearly mentioned in the balance sheet.

Verification of Building under Construction

- Auditor should verify the architect certificate and contractor receipt for the amount paid.
- Auditor should obtain a certificate from a responsible officer to that effect, if the staff of client is also engaged in its construction.

Verification of Leasehold Property

There should be separate accounting for freehold and leasehold property. Leasehold property is acquired for fix duration on lease. The Auditor should consider the following —

- Inspection of lease agreement for value and duration.
- Lease agreement should be registered with the registrar.
- Terms and condition of the lease should be properly complied for.
- The Auditor should examine the last receipt of rent to ensure the lease agreement is in continuation without any break due to nonpayment of rent.

Verification and Valuation of Current Assets

We will now discuss the verification and valuation of a few important current assets, cash and bank balance and sundry debtors.

Cash-in-hand

Cash-in-hand is verified by actual counting of cash. Cash-in-hand should be verified at the close of the business or on the date of the balance sheet. Counting of cash must be done in the presence of cashier. If physically verification of cash is not feasible for an Auditor due to branch located abroad or in remote area, the Auditor should ask the cashier to deposit all his Cash-in-hand in bank account on the last date.

It is the primary duty of an Auditor to verify the cash-in-hand and in case of non verification, the Auditor will be held responsible for breach of his duty. If there is heavy cash balance in hand at any time, the Auditor should immediately inform the management beforehand.

If the cashier is made accountable for payment to employees or others, the Auditor should carefully verify the same.

Cash at Bank

The Auditor needs to consider the following points for verification of cash at bank —

- The Auditor should prepare a bank reconciliation of account as on date. With the help of it, the Auditor will clearly come to know the status about the cheque issued but not yet presented in the bank and cheques deposited in the bank but not yet cleared. There are many kinds of frauds which are detectable through preparation of bank reconciliation of account.
- The Auditor should obtain different certificates from banks for different types of accounts like current account, fixed deposit account, savings account, overdraft account or cash credit account, etc.
- The Auditor should obtain a letter of confirmation of bank balances directly from banks.
- The Auditor should compare the bank balance as per the bank book and the pass book.
- If payments are deposited in foreign banks under exchange control regulation it should be verified by the Auditor.

Sundry Debtors

The Auditor is concerned with obtaining sufficient audit evidence to corroborate the management's assertion regarding the following —

- All amounts are recorded in respect of outstanding debtors as at date of Balance sheet.
- Valuation of debtors is appropriate and properly applied.
- That all the debtors are disclosed, classified and described in accordance with recognize accounting policies and practices.

The verification process of the debtors involves the following —

Examination of Records

- Auditor should satisfy himself about the validity, accuracy and recoverability of debtors' balance.
- Excessive discount allowed or bad debts written off should be verified.

Direct Confirmation Procedure

- Direct communication with debtors is the best way to ascertain whether the balances are accurate, genuine and undisputed.
- Debtors from whom confirmation of balances is required, the method of requesting confirmation is to be determined by the Auditor.
- Confirmation procedure may be carried out within a reasonable period from the end of the year.
- Replies received from debtors should be carefully gone through and in case, where balances do not agree, client should be asked to investigate.
- The Auditor must pay special attention to those balances for which confirmation is not received. They might be fictitious or made to conceal a fraud.

Steps for Verification

- Book debts can be verified by the books of accounts and those should be supported by sale documents.
- Book balances should be sent to debtors directly for confirmation. It will establish the existence of book debts.
- Ownership of book debts can be verified with the sales documents and the sales ledger.

- Debtors should enquire about any type of dispute with customers about discount, claim etc.

Steps for Valuation

- Debtor's ledger should be supported by sales ledger.
- Auditor should obtain list of book debts, bad debts written off and for provision for doubtful debts.
- Sundry debtors should be valued at realizable value.
- Confirmation of balances shows that valuation of debtors is correct.

Verification and Valuation of Fictitious Assets

We will now discuss the verification and valuation of the following fictitious assets —

Preliminary Expenses

Preliminary expenses are incurred at the time of formation and commencement of company. These expenses are of capital nature and include stamp duties, registration fees, cost of printing, legal costs, etc. These expenses are shown in the balance sheet. These expenses are written off during a span of time of 3 to 10 years. The Auditor should verify that un-written amount is shown in the balance sheet.

Discount on Issue of Shares/Debentures

The Auditor should see that the discount on issue of shares/debenture should be written off as early as possible and the balance amount should be shown in the balance sheet.

Verification and Valuation of Liabilities

Let us now understand the verification and valuation of liabilities —

Trade Creditors

Auditor should take the following important steps for the verification and valuation of Trade Creditors—

- Auditor should collect schedule of creditors and that should tally with ledger balances.
- Purchase ledger should be checked and verified with purchase register, purchase invoices and debit notes etc.
- Auditor should verify the discount received or receivable from creditors.
- Auditor should minutely check the purchase of first month and last month of the financial year to avoid any possibility of booking purchases of current year to next year or last year purchase to current financial year.
- Auditor should pay special attention on any unpaid amount stands in ledger of creditor since long. It might be possible that amount has misappropriated by the any official and balance stands as it is in books of accounts.
- Confirmation of balances should be done directly by the Auditor and if there is any kind of discrepancy that might be sorted out.
- Auditor should carefully study the hire purchase agreement to verify the purchases made on the basis of Hire-Purchase.

Loans

The Auditor should verify the following important points for verification and valuation of Loans —

- The Auditor should verify the amount of loan, type of loan, rate of interest and repayment terms, etc.
- He should collect and examine the agreement and certificate from bank in case loan is granted by any Bank or financial institutions.

- He should obtain balance confirmation from party from whom loan is accepted by the organization other than bank.
- Interest calculation should be duly checked by the Auditor according to agreement.
- Amount of interest due but not paid during the current financial year should be duly accounted for in books of accounts and should be shown as current liabilities.
- In case of company, the Auditor examines the borrowing power, register of charges and created charge should be registered with the Registrar of Companies.

Capital

Capital of a partnership firm can be verified through partnership deed, Bank book, cash book, etc. Capital of a company can be verified through following -:

First Audit

- In case of first audit, Memorandum of Association and Article of Association should be examined to know the maximum authorized capital.
- To verify the classes, number of shares issued, amount due on calls, amount received and pending amount of calls, the Auditor should examine the minute book, cash book and bank book.
- Examining of vendor agreement if shares are allotted to vendors.

Subsequent Audit

The Auditor should consider the following points for subsequent audits —

- Any addition in capital by fresh issue should be according to Sections 61, 64 and 66 of the Companies Act-1956.
- Authorized capital to be shown separately in the balance sheet.
- Issued and subscribed capital should be shown separately according to each class of shares.
- Shares allotted of each class as bonus shares along with source of issue.
- Amount of unpaid calls from Directors and others.
- Capital account should be shown as Equity Capital, if only one class of share is issued.
- Ascertain the amount called up in respect of each class of shares.
- The number of shares being allotted without payment being received in pursuant to contract.
- Date of redemption should be clearly shown with the earliest date of redemption, where company has issued redeemable preference shares.
- If any amount received earlier against forfeited shares that should be shown separately after adding it to share capital.
- Capital profit on issue of forfeited shares should be transferred to capital reserve account.